

The Director of Central Intelligence

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*Memo
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MEMORANDUM FOR: The Honorable William P. Clark
Assistant to the President
for National Security Affairs

FROM: Director of Central Intelligence

The first of the attached papers will indicate the concern of my National Intelligence Officer for Economics on the state of play of our East-West economic initiatives and what might be done to move them forward more satisfactorily. The second undertakes to define what we might reasonably aim to get out of the NATO study on East-West Economic relations.

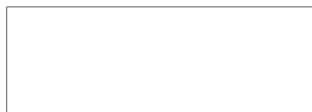
Bill
William J. Casey

Attachments:
As stated

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The State of Play on the East-West Economic Initiatives-- What We Might Expect from Our Allies

The initiatives begun by Secretary Shultz at La Sapiniere at best are likely to yield only modest progress in time for the next Economic Summit. Concrete progress is most feasible in the area of export controls because there is general Allied agreement on the desirability of limiting exports with specific military uses. The potential for instituting improvements in the COCOM system may not be realized, however, because of the US insistence on emphasizing oil and gas equipment, which is important to the Soviet economy, but has few direct military uses, in the COCOM study of "other technologies." The joint studies in NATO and OECD on the strategic implications of East-West economic relations and on energy, may help to sensitize our Allies and facilitate future policy discussions, but are unlikely to lead to any specific actions by the time of the Summit.

A major weakness of the current exchanges with our Allies on East-West economic issues is the absence of a consultative group involving the Big Seven. Major East-West issues, such as large Soviet gas projects, cannot be adequately handled in NATO, the OECD, or COCOM. Yet informal consultation on such projects is essential if major Allied frictions, such as those that developed over the Siberian gas pipeline, are to be avoided. We and the Allies have a common interest in doing what we can to avoid Soviet manipulation of our mutual political and economic issues and differences. Perhaps the Summit principals could agree on the formation of such an informal steering group in the future.

NATO Economic Study

The study of the implications of East-West economic relations for the Alliance is under way. The main problems appear to be bureaucratic: The low competence of the NATO Economic Staff; the parochialism of the NATO Economic Committee, which is unused to dealing with important topics; and the general tendency to compromise in order to avoid controversy. If the Study is going to be of any use, it must be brief and focused on the right issues, rather than long, encyclopedic, and largely irrelevant as has been the common pattern. The attached draft conclusions are, I believe, valid, defensible, and, in some form, saleable to our Allies. A thorough review of the entire paper at the senior analytical (non-policy) level is essential (see attachment). If early progress seems inadequate, we must be prepared to raise issues to higher levels.

OECD/IEA Energy Studies

This is the initiative which substantively is in the best shape. The IEA has done a great deal of work on energy markets, including natural gas, and is addressing most of the issues the US is concerned about. The study will:

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- o Assess the vulnerability of European gas consumers to supply interruptions, including from the USSR.
- o Show the potential growth in West European imports of Soviet gas in the 1990s and beyond--
- o Discuss alternative sources, including Norway.

However, the study is unlikely to make any concrete suggestions on steps--technical, economic, or political--that would be necessary to help bring Norwegian gas on stream. It will, therefore, be only a first step in the US effort to achieve this result; the harder part will come later.

OECD Work on East-West Trade and Finance

The OECD seems to be moving ahead to upgrade its effort to collect and analyze information on East-West trade and finance, including more frequent and comprehensive reporting of credits and debt. If this effort proves successful, NATO can make use of the same data for its purposes. On the whole, OECD analysis of East-West economic relations has been of high quality.

Little if anything, however, is likely to come out of the OECD that might provide a basis for additional restrictions on Western trade with the East. Declines in market interest rates have largely eliminated interest subsidies. What subsidies are provided on exports to the Eastern Bloc are considered by our Allies as non-discriminatory--for example, in the case of agricultural exports--and consequently as not falling under the agreement in the "non-paper."

The issue of whether the Soviet foreign trade monopoly has given Moscow undue gains from trade has been raised on many occasions, but with few useful results. Although Moscow's foreign traders are quick to take advantage of market conditions, there is little evidence that they have acted as monopolists or monopsonists. This reflects not only relatively small Soviet market shares for most goods, but also the fact that Soviet foreign traders have no control over Soviet production or domestic demand.

Other High Technology, Including Oil and Gas

The objective of this initiative, which is to be lodged in COCOM, has been unclear from the start. The basic problem is that it mixes two very different problems in a COCOM framework: (1) improvements in the selection of new technologies to be controlled and perhaps procedures for COCOM control; and (2) the special importance of Western oil and gas equipment and technology in the development of Soviet energy production and exports. The general principles agreed upon in the "non-paper" and reiterated by our Allies are entirely consistent with the first

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objective. But there appears to be no basis for agreement on the desirability of restricting exports of oil and gas equipment, except those few which have specific military applications, because the Allies do not regard the growth of the Soviet economy or of Soviet hard currency earnings to be undesirable as such.

In the view of some COCOM experts, present COCOM policies and procedures are inadequate in several respects:

- o The COCOM control lists cover very little in the way of disembodied technology--they concentrate on physical equipment. Such technology, however, can be extremely important to the Soviet military.
- o The only occasion in COCOM for bringing Allied technical expertise systematically to bear on export control issues comes during the list reviews, which takes place every three years. Such a review is now in progress and is going fairly well. In between list review, countries may suggest additions to the lists, but there is rarely a satisfactory technical exchange. In view of the rapid pace of technology development today, the technical review process needs to be done on a continuous basis.
- o COCOM deals with products and technologies which have clearly identifiable military uses. DOD is properly concerned about emerging technologies which do not yet, but probably will, have major military application. Furthermore, the most advanced technologies being developed in the West today are for commercial, not military, purposes. Later, perhaps as much as three to five years later, these advanced civilian technologies are being applied to new military weapons systems. These too need to be controlled in some fashion.

Proposals such as these are likely to find some support among our Allies. For example, the Germans have recently proposed that a fourth COCOM list--for disembodied technologies--be established. The French also claim to be strongly behind the effort to improve COCOM, and may have some creative ideas.

Unfortunately, US insistence on COCOM treatment of oil and gas equipment and technology may get in the way of progress along these lines. Unless the effort to improve COCOM (in addition to the present list review) is more clearly thought out and better focused, we may miss a major opportunity to make some concrete progress before the Economic Summit.

NATO Study on East-West Economic Relations:**Possible Conclusions**

1. The USSR uses its economic relations with the West to build its military power and international influence in the following ways:
 - o To ease the burden of defense by helping to cope with economic problems and to stimulate productivity.
 - o To help build the industrial base for military production.
 - o To obtain specific technologies essential to the modernization of weapons systems.
 - o To help finance foreign assistance activities.
2. Although the Soviet economy has achieved a high degree of self-sufficiency, East-West trade has a much greater importance to the USSR than its market value alone would suggest:
 - o Soviet imports from the West consist mainly of goods and technologies which the USSR cannot currently produce, are in very short supply (e.g., grain, steel), or are far more advanced technologically than available domestic substitutes.
 - o These characteristics of Soviet imports from the West are reflected in the fact that imports are about three times larger relative to Soviet GNP in rubles than in dollars (over 5 percent of Soviet GNP).

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- o Soviet imports of machinery and equipment from the West in recent years have constituted about 10 percent of the ruble value of investment in machinery and equipment.
 - o Imports of Western steel have partly compensated for major shortfalls in domestic steel production, and imports of steel pipe have been of critical importance to the development of the massive West Siberian gas reserves.
 - o Massive imports of Western grain and other foods have made it possible to sustain food supplies without large slaughtering of livestock.
3. Soviet economic growth has slowed to the point that Moscow can no longer simultaneously achieve its military and civilian objectives to a reasonable degree.
- o The economic slowdown is due primarily to fundamental demographic and productivity trends, which are unlikely to improve and may worsen.
 - o Among the principal factors in declining productivity growth are: rapidly rising energy costs; severe transportation bottlenecks; shortages of steel and other major products; and low worker morale. The new Soviet leadership may be able to temporarily boost productivity, but is unlikely to make a lasting change.
 - o With GNP growth about 2 percent or less, the burden of defense is rising and Moscow has been forced to greatly slow the growth of investment. In turn, slow investment growth is contributing to slower modernization and capacity bottlenecks.

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- o The slowdown in the economy, including key industries such as steel and machinery, which strongly contribute to military production, has made it more difficult to insulate military programs from economic difficulties. In recent years, military hardware procurement apparently has leveled off. Although we do not know all the reasons, these clearly include problems with supply of key industrial inputs. It would indeed be surprising if economic difficulties were not having an impact on military programs, given the complexity of the economy and the close dependence of industries on each others' performance.
 - o Although no major change in Soviet priorities is likely in the near term, the Soviet leadership is likely to consider in the future the possibilities for improving economic performance by lowering military expenditures. Unless productivity can be substantially improved, which is unlikely, a continuation of the rapid military build up of the 1970s will mean little or no improvement in living standards in the 1980s. It is uncertain whether either the leadership or the population would accept such an outcome.
4. An expansion of imports from the West would be of considerable benefit to the Soviet economy by helping to stimulate productivity.
- o Prospects for an expansion of Soviet hard currency earnings depend primarily on how much gas exports can be increased. If alternative energy sources are not developed, there is a potential market in Western Europe in the 1990s for a substantial increase in Soviet gas exports to that area.

- o In the next few years Soviet hard currency earnings are unlikely to increase because of stagnating or falling oil production and soft energy markets. Rapid growth could resume in the 1990s, depending on gas sales and energy markets.

- o Moscow has followed conservative hard currency payments and debt policies and will probably continue to do so at least through 1985. The new Soviet leadership will be considering whether or not to seek increased Western credit as a means of stimulating imports in the next (1986-90) five year plan. Whether or not Moscow exercises this option will depend in part on how accommodating Western credit policies are.

5. Hard currency constraints have some direct and indirect effects on Soviet military and foreign policy programs.

- o When foreign exchange is in particularly short supply, as it was in 1981, Soviet programs which are of relatively low priority, or are unpopular in some domestic political circles, have received cuts (for example, some programs involving hard currency aid for LDCs or client states).

- o The bureaucratic process of allocating shortfalls in foreign exchange, as for other key inputs, typically entails broad across-the-board cuts, which adversely affect some high priority military and foreign policy programs that have not been explicitly exempted.

- o The tendency to give priority to imports of consumables in allocating scarce foreign exchange, in order to avoid major

shortages, results in imports of machinery and equipment being squeezed. A result can be an unintended slowdown in the development of industries important to military production.

6. Soviet military hardware, which was at one time distinguished for its rugged simplicity, has been qualitatively improved until it is in some instances the technological equal of--if not superior to--military hardware produced in the West. Without Western technology, modernization and qualitative improvement of Soviet military equipment would have proceeded at a slower pace. The Soviets have turned to legal and illegal acquisitions of Western technologies to make up for domestic shortcomings. They have thereby been able to satisfy certain R&D and production objectives:

- o The reduction of engineering risk by following or copying proven Western designs.
- o The reduction of R&D time by several years through the use of Western designs and technology and equipment.
- o The incorporation of countermeasures early in the Soviet weapon development process.
- o In addition, the Soviets have been able to upgrade critical industrial sectors such as computers, microelectronics, and metallurgy.

7. Although the dependence of the Western economies on economic relations with the USSR is small, opportunities for Soviet political and economic leverage do exist.

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- o The Soviet market is important for a few Western industries, such as steel and certain types of equipment which are experiencing depressed world demand and basic structural problems.
- o The expansion of Soviet gas exports may create local vulnerabilities in Western Europe even though alternative sources were available in most of the area.
- o Should large additional gas projects be developed, West European dependence on Soviet gas could become dangerously large in the 1990s and beyond.
- o Moscow's monopoly of foreign trade gives it opportunities to manipulate Western firms, governments, and political and economic interests in order to gain economic concessions and to weaken the Alliance. This is particularly true in the case of large projects.

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